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Tax-Exempt Investment for the Caribbean Basin Initiative Region

Effective January 1, 1987, amendments to section 936 of the U.S. Internal Revenue Code (26 U.S.C. 936) provide a tax exemption for certain investments in qualified Caribbean Basin countries. As a result of these amendments, investment funds available from qualified Puerto Rico financial institutions can now provide a relatively low-cost source of funding for low-risk projects in qualified Caribbean countries. Given the strategic importance of the Caribbean region, located on America's front porch, and the difficult economic conditions in the region, the availability of these funds may serve to assist economic development in the Caribbean while providing tax-free income to qualified investors.

I. Background

In 1986 Congress reviewed various U.S. tax code provisions with an eye toward increasing revenues for the federal government. Section 936 was subject to particular scrutiny. This section virtually eliminated U.S. tax on certain manufacturing and investment income earned from the operations of U.S. corporations in the Commonwealth of Puerto Rico.

The Government of Puerto Rico had, however, built its economic growth on the keystone of section 936. Besides providing direct employment for over 100,000 people,[1] section 936 had led to the creation of a $14 billion pool of funds (936 funds) available for investments in Puerto Rico at fairly low interest rates.[2] The Puerto Rican Government therefore viewed with alarm the possibility that Congress might eliminate this provision. In an effort to retain the benefits of

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1. Economic Dev. Admin., Commonwealth of P.R., Section 936 and Economic Development in Puerto Rico 1 (1989).

2. Department of the Treasury, Sixth Report, The Operation and Effect of the Possessions Corporation System of Taxation 74 (1989) [hereinafter Sixth Report]. There is no specific legal definition for 936 funds. In practice, however, the term "936 funds" is commonly used

section 936 for Puerto Rico, as well as persuade Congress of its potential value to the region, the Governor of Puerto Rico, Rafael Hernandez Colon, proposed expanding section 936 to allow for a portion of the 936 funds to be invested in other countries of the Caribbean.[3] Governor Colon argued that this would benefit both Puerto Rico and the United States by promoting political stability in the Caribbean region and reducing the emigration of Caribbean people to Puerto Rico and the United States. These goals were viewed as particularly important to policymakers because of the proximity of the Caribbean countries to both Puerto Rico and the United States.

Various levels of section 936 support for the region were discussed by the Congress and the Government of Puerto Rico. In a Draft Memorandum of Agreement between the United States and Puerto Rico, the Government of Puerto Rico proposed a good-faith effort to provide $100 million per annum in 936 funds to the Caribbean in return for the retention of section 936.[4] Ultimately, the United States Congress did retain section 936. At the same time it expanded the section to allow for the investment of 936 funds in other countries in the Caribbean as well as Puerto Rico.[5] Due to concerns by the Congress over the initial slow pace of getting 936 funds into the Caribbean, Congress, on July 30, 1990, amended section 936 to *require* the Government of Puerto Rico to ensure that at least $100 million be contributed to qualified Caribbean Basin investments annually.[6]

II. Section 936 and Puerto Rico Tax Exemption

Under section 936 income earned by an eligible U.S. company (a 936 corporation) operating an active trade or business in Puerto Rico may receive a tax credit to offset the U.S. tax otherwise attributable to the income earned from its Puerto Rico operations. This credit is available irrespective of whether the active income so generated is immediately repatriated back to the United States or is

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to denote the active income and the passive qualified possession source investment income earned by 936 corporations while such funds are retained and reinvested in Puerto Rico or a qualified CBI country.

3. HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1985, H.R. REP. NO. 426, 99th Cong., 1st Sess. 419 (1985).

4. Draft Memorandum of Agreement, United States-Puerto Rico, Nov. 14, 1985.

5. I.R.C. § 936(d)(4). Additionally, the government of Puerto Rico initiated a "twin-plant" program (now known as Puerto Rico's Caribbean Development Program) under which Puerto Rico economic development officers promote the relocation of companies, particularly from the Far East, to the Caribbean. These companies, it was conceived, would establish "twin-plants": one plant in a Caribbean country to take advantage of the low cost labor available in these areas and a "twin-plant" in Puerto Rico where the more capital intensive portion of the operation might be accomplished.

6. *See* I.R.C. § 936(d)(4)(D) (West Supp. 1991) (effective for calendar years after 1989); H.R. 1594, 101st Cong., 2d Sess., 136 CONG. REC. H5887, H5896 (daily ed. July 30, 1990).

retained in Puerto Rico. Additionally, under Puerto Rico law, when a corporation has received a tax exemption grant from the Government of Puerto Rico, the qualified income earned from its Puerto Rico operations will also be exempt (generally up to 90 percent) from Puerto Rico tax.[7] However, under Puerto Rico law, if a corporation transfers the 936 funds out of Puerto Rico as earned, the Puerto Rican treasury levies a tollgate tax. The tollgate tax rate depends on the type of operations that generated the income and when the repatriation occurs. Most 936 manufacturing corporations that immediately repatriate income as earned would pay a 10 percent tollgate tax.[8]

Section 936 also allows the active income earned by a 936 corporation to be invested in certain eligible activities in Puerto Rico and if so invested, the passive income generated will be exempt from U.S. tax (Qualified Possession Source Investment Income or QPSII).[9] Again, Puertó Rico law similarly exempts certain QPSII from Puerto Rico tax.[10] Additionally, if 936 funds are invested in Puerto Rico for longer periods of time (five years or more) and in qualified investments deemed to be of benefit to the economic development of Puerto Rico, then the Puerto Rico Government will reduce or eliminate the tollgate tax when the funds are ultimately repatriated.[11]

The cumulative effect of these provisions of U.S. and Puerto Rico tax law has been significant. Puerto Rico has become a major manufacturing center. By 1983 a total of six hundred and twenty-five 936 corporations had established operations in Puerto Rico,[12] providing direct employment for over 100,000 people on the island.[13] By 1990 total exports of goods and services from Puerto Rico had reached $19 billion, ahead of every country in Latin America and the Caribbean except Brazil ($34.6 billion in 1989) and Mexico ($22.7 billion in 1989).[14] Per capita GNP in Puerto Rico rose from $586 in 1947 to approximately $2,410 in 1988.[15] By 1983 the 936 corporations had earned annual net profits of over $4 billion from their operations in Puerto Rico.[16] While 936 corporations repatriated over $2 billion of such income from Puerto Rico,[17] they paid taxes and invested

7. Puerto Rico Tax Incentives Act § 3, 13 L.P.R.A. § 256b(a) (Supp. 1988) (approved Jan. 24, 1987).

8. *Id.* § 256c(a).

9. I.R.C. § 936(d)(2).

10. 13 L.P.R.A. § 256a(j)(3).

11. *Id.* § 256(j).

12. SIXTH REPORT, *supra* note 2, at 31.

13. *See* ECONOMIC DEV. ADMIN., *supra* note 1.

14. Caribbean Business, Nov. 29, 1990, at 10.

15. SIXTH REPORT, *supra* note 2, at 17, 22. According to the Sixth Report, from 1947-1973 per capita GNP in Puerto Rico rose from $586 to $2,112. *Id.* at 22. Real GNP per capita changed little from 1972-1983. *Id.* at 17. GNP recovered from the 1982 recession in 1984 and 1985. *Id.* Per capita GNP increased at a compound growth rate of 4.5 percent from 1985 to 1988. *Id.*

16. *Id.* at 40.

17. *Id.*

the remaining earnings in eligible activities in Puerto Rico, raising eligible investments by year-end 1986 to $14.7 billion.[18]

The 936 corporations invested about $3.7 billion of these 936 funds directly in Puerto Rico housing and real estate (generally through United States or Puerto Rico government agency guaranteed pools (such as GNMA mortgages)). Additionally, the 936 corporations invested approximately $8.8 billion of these 936 funds in deposits at eligible depository institutions (such as Puerto Rico banks and Puerto Rico branches of U.S. and foreign banks), which in turn reinvested such 936 funds in qualified eligible activities such as local industrial, commercial, governmental, and housing loans.[19]

III. The Benefit of 936 Funds

Section 936 funds are generally available to qualified borrowers directly from 936 corporations or indirectly from eligible depository institutions. The base rate of interest charged for such funds is generally lower than for conventional loans because the interest received by the lender of 936 funds is generally exempt from both U.S. and Puerto Rico tax. Thus, the lender can pass a portion of the tax benefit on to the borrower in the form of a lower interest rate.[20]

The actual interest rate paid for 936 funds is the result of supply and demand forces in an active local capital market. Generally, 936 funds are available at a base rate of interest equal to approximately 85 percent of the equivalent maturity

18. *Id.* at 74.

19. *Id.* The status of Puerto Rico and its relationship with the United States remains a key variable for the future of section 936. A bill has been introduced in Congress by Senator Bennett Johnston, D-La., to authorize a plebiscite on the island. S. 244, 102d Cong., 1st Sess., 137 CONG. REC. S1055-69 (daily ed. Jan. 23, 1991). It is proposed that this vote would determine whether Puerto Rico remained a Commonwealth, became a state, or became independent. Under the proposed bill, if the status of Puerto Rico were to change, the benefits of section 936 would be phased out. Given the procedural delays inherent in establishing such a plebiscite (certainly not before 1994), and the relatively long phase-out period contemplated (five years), it is unlikely that any change to section 936 will impact on current projects financed with 936 funds. Should Puerto Rico's status change, new financings with 936 funds might be curtailed in the later half of the 1990s.

20. For example, a 936 company can choose to transfer its 936 funds out of Puerto Rico, pay the Puerto Rico tollgate tax, and then lend such (now) conventional funds to a U.S. borrower. Assume that the 936 corporation receives a 10 percent rate of interest on such a loan. Assume further that the 936 corporation has to pay a 30 percent tax on such interest income to the U.S. Treasury. The 936 corporation would, therefore, receive an after-tax yield of 7 percent (less the tollgate tax). On the other hand, if that 936 corporation chose to retain the 936 funds in Puerto Rico and loan 936 funds to a qualified recipient at an 8 percent rate of interest, there would be no tax to pay on such interest income and the after-tax yield to the 936 corporation would be 8 percent. Additionally, if the funds were invested for a sufficient time in Puerto Rico, no tollgate tax would be applied upon repatriation of the funds. Clearly, the 936 corporation would prefer to loan 936 funds to a qualified recipient at 8 percent rather than repatriate 936 funds to the United States and then loan them in the United States for an after-tax yield of 7 percent. At the same time, a qualified recipient would prefer to pay 8 percent interest for 936 funds rather than 10 percent for conventional funds.

London Interbank Offering Rate (Libor).[21] For example, the current three-month Libor stands at 8.2 percent.[22] The equivalent 936 base rate would be about 7 percent (8.2% × 85% = 7%). The benefit to the borrower in receiving 936 funds instead of conventional funds might, therefore, equal a lowering of the interest cost by approximately 1.2 percent (120 basis points) per annum.

IV. 936 Funds in the Caribbean

Effective January 1, 1987, the United States Congress expanded section 936 to allow favorable tax treatment for the investment of 936 funds in eligible activities in qualified Caribbean Basin countries. Under section 936(d)(4), funds that are generated by the operation of an exempted business in Puerto Rico can be invested in a qualified Puerto Rico financial institution for investment in the Caribbean. The income generated by such investment qualifies as QPSII and is exempt from U.S. tax. A similar exemption from Puerto Rico tax applies under Puerto Rico law.[23]

Under section 936(d)(4), 936 funds can only be invested in qualified Caribbean Basin countries designated under the Caribbean Basin Economic Recovery Act of 1983 (the Caribbean Basin Initiative or CBI).[24] Twenty-three countries are so designated and qualified.[25] Congress also requires that to be eligible for such tax-exempt funds the CBI qualified countries must enter into a Tax Information Exchange Agreement (TIEA) with the United States.[26]

The purpose of the TIEA is to allow the United States and CBI Governments to share tax and other information that could lead to the arrest and conviction of drug traffickers, tax evaders, and other criminals. The rationale for the TIEA is that it leaves such criminals without some of the protections otherwise afforded by foreign residency and relieves the confusion and jurisdictional problems encountered by law enforcement agencies when portions of an illegal enterprise occur in various countries.[27] Tourism is also benefitted when a CBI country signs a TIEA. Under the U.S. tax code, U.S. taxpayers may deduct from their U.S. taxes any business convention expenses they incur in CBI countries.[28] To date,

21. SIXTH REPORT, *supra* note 2, at 84.
22. Wall St. J., Dec. 26, 1990, at 29.
23. 13 L.P.R.A. § 256a(2)(j)(A).
24. Caribbean Basin Economic Recovery Act § 212, 19 U.S.C. § 2702 (1988).
25. Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, British Virgin Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Panama, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago. Nicaragua has requested designation. The administration is reviewing that request. As at December 26, 1990, from U.S. Department of Commerce.
26. I.R.C. § 936(d)(4)(B).
27. Remarks by Peter D. Whitney at the Caribbean Basin Conference, San Juan, Puerto Rico (Oct. 19, 1988) (on understanding the Tax Information Exchange Agreement).
28. *Id.;* I.R.C. § 274(h)(6).

Barbados, Costa Rica, Dominica, Dominican Republic, Grenada, Jamaica, and Trinidad and Tobago have executed fully applicable TIEAs with the United States Government.[29]

Another requirement under U.S. law for the qualified investment of 936 funds in the Caribbean is that such funds be invested in "active business assets" or "development projects" in a qualified CBI country.[30] The Senate Finance Committee Report that accompanied the CBI amendment to section 936 states: "A development project generally means an infrastructure investment, such as a road or water treatment facility, that directly supports industrial development. Active business assets generally means plant, equipment, and inventory associated with a manufacturing operation."[31]

The Regulations issued by the Department of the Treasury, implementing the CBI amendment to section 936, detail what constitutes "active business assets" and "development projects."[32] The Regulations broadly permit qualified investment in tangible personal property used in a trade or business in qualified CBI countries, including reasonable incidental expenditures (such as installation costs). Section 936 funds can only be provided to qualified CBI projects for new investments. However, the Regulations permit the construction, the rehabilitation, the improvement, or the upgrading, of qualified CBI assets. An investment in used tangible personal property employed in the same CBI country within the last five years may not qualify.[33] Moreover, 936 funds may not be provided to refinance existing project facilities.[34] However, the United States Treasury may approve the use of 936 funds to refinance some privatization transactions on a case-by-case basis.[35] The Treasury Department believes that in some transactions where a qualified CBI government is turning over state-owned facilities to the private sector, sufficient positive developmental benefits may exist to allow a portion of the purchase price to be financed by 936 funds. Generally, only up to 10 percent of the qualified investment of 936 funds in a CBI project can be utilized to finance working capital used by the CBI business.[36]

Under section 936(d)(4), a 936 company that generates 936 funds will not receive favorable tax treatment if it invests its funds directly in otherwise qual-

29. *Use of Section 936 Funds for Loans in the Caribbean Region Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 101st Cong., 2d Sess.* 101-97, at 7 (1990) (statement of Kenneth W. Gideon, Assistant Secretary for Tax Policy, U.S. Department of the Treasury) [hereinafter Gideon].

30. I.R.C. § 936(d)(4)(A)(i).

31. SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1986, S. REP. NO. 313, 99th Cong., 2d Sess. 384 (1986).

32. Requirements for Investments to Quality Under Section 936(d)(4) as Investments in Qualified Caribbean Basin Countries, Treas. Reg. § 1.936-10(c)(4), (5) (May 10, 1991).

33. *Id.* § 1.936-10(c)(4)(ii).

34. Gideon, *supra* note 29, at 4.

35. *Id.* at 5.

36. Treas. Reg. § 1.936-10(c)(4)(iii)(C).

ified CBI projects. Instead, in order to receive favorable tax treatment, the 936 company must invest through a qualified financial institution.[37] Under the Regulations a qualified financial institution is defined as the Government Development Bank for Puerto Rico, the Puerto Rico Economic Development Bank, a "banking, financing or similar business" that is "organized under the laws of the Commonwealth of Puerto Rico or is the Puerto Rican branch" of such a business,[38] and which is an eligible depository institution for 936 funds as qualified by the Commissioner under Puerto Rico regulations,[39] or "such other entity as may be determined by the Commissioner of Financial Institutions for Puerto Rico" or a "single-purpose entity" established in Puerto Rico as an eligible institution solely to invest 936 funds in qualified CBI assets.[40]

Another requirement of section 936(d)(4) is that the recipient of 936 funds in the Caribbean open its books and records to the United States and Puerto Rico Governments to assure that the 936 funds are being used in accordance with the law.[41] Section 936(d)(4) also requires that the lending of 936 funds to a qualified Caribbean recipient be approved by the Commissioner of Financial Institutions for Puerto Rico.[42] The circumstances under which the Commissioner will approve such lending are discussed below.

V. Puerto Rico Law and Regulation Governing 936 Investment in the Caribbean

The Commissioner of Financial Institutions for Puerto Rico has issued regulations for the investment of 936 funds in the Caribbean.[43] Under these regulations the project must first be endorsed by the Economic Development Administration of Puerto Rico (Fomento). Fomento will determine whether, on balance, the project is of benefit to Puerto Rico or whether and to what extent the project has a materially adverse impact on Puerto Rico.

If the project provides benefit to Puerto Rico, such as creating jobs or revenues in Puerto Rico, then Fomento may endorse the project. If the project has no materially adverse impact on Puerto Rico, even if it provides no benefit to Puerto Rico, then Fomento may still endorse the project and the Commissioner may still approve the lending of private 936 funds to the project. However, where the project is found, on balance, to have a materially adverse impact on Puerto Rico,

37. I.R.C. § 936(d)(4)(A).

38. Treas. Reg. § 1.936-10(c)(3).

39. *Id.* § 1.936-10(c)(3)(ii)(B); Puerto Rico Regulation 3582, Eligible Institutions Regulation, § 4.2.13, Commissioner of Financial Institutions, Jan. 29, 1988.

40. Treas. Reg. § 1.936-10(c)(3).

41. I.R.C. § 936(d)(4)(C)(iii).

42. *Id.* § 936(d)(4)(A)(ii).

43. Puerto Rico Regulation 3703, Qualified CBI Loans Regulation, Commonwealth of Puerto Rico, Office of the Commissioner of Financial Institutions, Financial Board, Economic Development Administration, June 22, 1988.

Fomento will not endorse the project and the Commissioner will not approve the lending, private or public, of 936 funds to the project.

Additionally, in order for a qualified Puerto Rico financial institution to invest 936 funds in the Caribbean it must obtain the approval of the Commissioner for the specific CBI investment.[44] The Puerto Rico regulations further require, in order to assure proper investment in accordance with law and regulation, that the financial institution that makes a CBI investment comply with rigorous due diligence rules.[45]

If the investment is endorsed by Fomento and approved by the Commissioner, then Puerto Rico law provides beneficial tax and regulatory treatment to such investment. Under regulations issued by the Puerto Rico Commissioner a qualified 936 CBI investment can be used by an eligible depository institution to meet Puerto Rico reserve requirements.[46] Under these regulations all financial institutions holding 936 funds must invest at least 7 percent of such funds in a list of preferred investments. Qualified CBI investments are included in this list.

Under Puerto Rico regulations, qualified CBI investments also provide a benefit to financial institutions by their effect on the "tablita" requirement. This requirement provides that Puerto Rico financial institutions that pay high rates of interest to attract 936 deposits must invest more funds in certain eligible activities deemed to be of benefit to Puerto Rico. The effect of this requirement is to reduce the income received by such financial institutions. Qualified CBI investments assist a Puerto Rico financial institution making such an investment by reducing the amount of additional eligible activity otherwise required. For each qualified 936 CBI dollar invested, a Puerto Rico financial institution can reduce its otherwise required investment in eligible activities by 25 percent of such CBI investment.[47]

VI. Qualified Caribbean Basin Country Regulations

For projects in qualified CBI countries to access 936 funds, the host government will normally require the project to seek the approval of that CBI government. Most CBI countries place tight restrictions on companies within their jurisdiction taking cross-border loans and investments. Approval by the central bank of the CBI country is typically required for such loans. Additionally, several governments in the region are now operating under letters of intent with the International Monetary Fund (IMF) and are under contractual agreements with commercial banks that limit the amount of allowable indebtedness. In many CBI countries these provisions therefore require CBI governmental approval before any new 936 borrowings can occur.

44. *Id.* § 5.1.3; Regulation 3582, § 6.2.4(e)(ii).
45. Regulation 3703, art. 6; Regulation 3582, § 6.4.
46. Regulation 3582, § 6.1.3.
47. *Id.* § 6.3.3.

Most CBI area countries impose withholding taxes on the interest income or dividends repatriated from enterprises in their countries. For borrowers to receive the benefits of the lower 936 interest rate, CBI governments will need to exempt 936 loans from such withholding taxes.

VII. Qualified Puerto Rico Financial Institutions

Due to the nature of 936 funds, which are free to leave Puerto Rico at any time, qualified Puerto Rico financial institutions have generally invested 936 funds in only the highest credit, quality activities. Holders only choose to invest such funds in Puerto Rico because of the tax advantage they receive. This tax advantage may provide a benefit of only 1 percent or 2 percent per annum (100 to 200 basis points). This relatively small benefit would be outweighed if the risk of such investments were increased too far. Few holders of 936 funds would place their 936 funds at great risk for an increased benefit of just 1 percent or 2 percent annually. Since cross-border lending into the qualified CBI countries can give rise to additional risks, only well-structured financings, which greatly reduce such risks, can be expected to be acceptable to 936 lenders.

Many of the qualified CBI countries are experiencing difficult credit conditions. Most qualified Puerto Rico financial institutions have limits on the dollar amount of risk exposure available to such countries. In this environment significant amounts of private 936 funds will be made available only to projects with guarantees from high credit, quality countries.[48]

VIII. Conclusion

Recent changes to section 936 of the U.S. Tax Code allow relatively lower cost funds to be made available for high credit, quality projects in the Caribbean. To date, qualified Puerto Rico financial institutions have invested over $188 million in 936 funds for nine projects in five qualified Caribbean Basin countries.[49] If properly utilized, this program should reduce interest costs for qualified CBI area projects and assist the economic development of the Caribbean as well as provide tax-exempt income to qualified investors.

48. Gideon, *supra* note 29, at 5. For example, a qualified Puerto Rico financial institution may loan 936 funds to a project in a qualified Caribbean Basin country with a guarantee from the parent corporation of the project where the parent corporation is located in a developed nation (such as the United States) and is of a very high credit quality.

49. 1 FOMENTO'S CARIBBEAN HIGHLIGHTS (1990).